Wentz Weekly

January 31, 2022

Fed Uncertainty

Investment management for your lifetime

The Federal Open Market Committee's policy statement was about as expected as could be – rates were unchanged as economic growth and employment continuing to strengthen with rate increases appropriate soon. This was evident by the market's immediate reaction to move higher. However those gains were short lived. The Fed, in a rare but necessary instance, issued a separate statement to introduce its plans to begin reducing its balance sheet that grew to almost $9 trillion (from $4 trillion pre-covid) as a result of its quantitative easing program. The fact is the economy is doing well enough that support from the Fed is no longer necessary and if continued could lead to more persistent inflation and an overheated economy which has the potential to cause a more severe downturn (recession). To prevent this, the Fed is going to attempt a "soft landing," or a situation where the Fed tightens monetary policy (increases rates to a more normal level while shrinking its balance sheet) steady enough to not shock the economy (push it into a recession).

We believe the Fed's goal during last week's meeting was to indicate a March rate increase, as the market expects, and warn markets there may be more than four rate increases this year if inflation remains high, while introducing the balance sheet discussion and a plan to begin shrinking the massive balance sheet by mid-year. While the Fed did this, they left the markets with uncertainty on the timing and pace of tightening, and we know when there is uncertainty volatility picks up and a selloff from risk assets such as equities follows. Regarding rates, the market expected four increases in 2022 (one every other meeting), but Powell hinted at the possibility of consecutive rate increases and the markets are now seeing the highest probabilities of five increases in 2022. More importantly, the press conference had many questions on the Fed's plan on shrinking its $9 trillion balance sheet. We believe the Fed used this meeting as an opportunity to tell the markets they are now discussing a plan, which they will likely announce two meetings after its first rate increase (timing makes this the June meeting). But Powell refused to give details and left the market with more questions than answers. The result of the Fed meeting was a move higher in yields, particularly on the short end of the curve where the 2-year Treasury note moved 13 basis points higher (0.13%) while the 30-year yield only move 5 basis points higher, resulting in a flatter yield curve (a flattening or inverted yield curve could suggest markets are pricing in a higher probability of a recession). Markets do not like uncertainty and until we get better direction from the Fed, we believe the volatility will continue.

Last week we received our first indication on fourth quarter economic growth via the GDP report from the Bureau of Economic Analysis that showed the economy grew at an annualized rate of 6.9%, a strong beat compared to the 5.5% increase expected. The increase was led by a strong increase in inventories which added 4.9% to growth as businesses and suppliers looked to restock after running low on inventory for much of the past year. Consumer spending, making up approximately 70% of GDP, added 2.25% to GDP thanks to a 3.3% increase in spending. Nonresidential investment, which has been weak in recent years, grew 2.0% and contributed 0.3% to GDP, offset by a -0.8% decline in residential spending as the housing market cools. Trade activity surged, especially exports which grew 24.5%, offset by a 17.7% increase in imports, resulting in net exports to contribute 0% to GDP. Lower government spending offset those gains, falling 2.9% and contributing -0.5% to GDP. Overall, Q4 GDP was a very strong report that mostly reflects the strong consumer and businesses restocking shelves. For the calendar year 2021 the economy grew at a 5.7% pace, a rebound from its 3.4% decline in 2020 (the worst since WWII).

A large contributor to GDP is the personal income and outlays report which reflects consumer spending and incomes. In December, consumer spending fell 0.6%. A larger decline was expected due to the shift in the timing of consumer's holiday shopping, which many did earlier in October and November compared to prior years, along with the resurgence of Covid with the Omicron variant. Personal income rose 0.3% in the month, slightly less than expected. The more important figure to watch, wages and salaries, continue the hot streak rising another 0.7% in the month. The increase in wages is decelerating though (as expected due to the base effect – comparing to higher numbers from the year ago period), increasing 9.8% from a year ago after a 12.8% and 11.4% increase from the prior two months. The result of income and spending is a savings rate of 7.9%, an increase from 7.2% in November and near historical averages.

Earnings continue to roll in with roughly 1/3 of the S&P 500 reporting so far. To date, the earnings growth rate is 30%, higher than the 22% increase expected when the quarter began, while revenues have grown 15%. Earnings multiples will come down as the Fed tightens policy, so 2022's question is can companies grow earnings enough to offset the decline in multiples in the face of higher costs. Highlights last week include Apple's record quarter thanks to strength in iPhone sales and service revenue. Microsoft beat as well with an upbeat forecast for the current quarter driven by strength in its cloud computing segment. Tesla easily beat expectations too but investors grew concerned over the supply chain issues that are hampering production for the auto maker. Boeing missed estimates but reported positive cash flows, a surprise, but said it is taking another $3.5 billion in charge related to the delays in its 787 production.

Company News

- Nvidia traded lower last week after a Bloomberg report said it is planning to abandon its planned acquisition of ARM Holdings due to its expectation the deal will not be finalized due to regulatory concerns. The Federal Trade Commission sued last month to block the deal on antitrust concerns.
- General Motors said it is investing more than $7 billion in four Michigan manufacturing facilities to increase manufacturing capacity. The investment includes a new Ultium Cells battery cell plant in Lansing and converting its assembly plant in Orion Township for the product of EVs. The investments will add another 4,000 new jobs.
- Facebook has indicated it is looking to sell its asset in its cryptocurrency initiative where it was seeking to create a stablecoin (first called Libra).

The Week Ahead

It will be another busy and important week as we welcome in February on Tuesday. Over one-fifth of S&P 500 companies are expected to report quarterly results this week. Notable reports on the earnings calendar include: Ryanair on Monday; Alphabet, Advanced Micro Devices, UPS, Starbucks, GM, and Exxon Mobil on Tuesday; Qualcomm, Facebook, Sony, and T-Mobile on Wednesday; Amazon, Ford, Snap, and Merck on Thursday; and finally Bristol Myers wrapping up the week on Friday. The highlight on the economic calendar is the employment report on Friday where the consensus sees 150,000 new jobs added in December. There will also be several manufacturing surveys released on Tuesday, along with the job openings and labor turnover survey and December construction spending. On Thursday we will see the report on weekly jobless claims and data on fourth quarter productivity and labor costs. The energy sector will be focused on the OPEC meeting for any indication on production changes from the group. Crude oil is at nearly $90/barrel, up over 50% from a year ago and the highest since 2014. In non-market news, the 2022 Winter Olympics begin this week with the opening ceremony set for Friday.